IN THE

Supreme Court of the United States

October Term, 1951.

No. 158.

Thomas B. Lilly and Helen W. Lilly, *Petitioners,*

v.

Commissioner of Internal Revenue, *Respondent.*

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit.

BRIEF FOR THE PETITIONERS.

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OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 176-196), Judge Arundell dissenting (R. 196-199), is reported in 14 T. C. 1066. The opinion of the United States Court of Appeals for the Fourth Circuit (R. 224-229) is reported in 188 F. 2d 269.

JURISDICTION.

The judgment of the United States Court of Appeals was entered on April 2, 1951. (R. 229.) A petition for a writ

of certiorari was filed on June 29, 1951, and was granted on October 8, 1951. (R. 193.) The jurisdiction of this Court rests on 28 U.S.C. Section 1254(1), 62 Stat. 928.

QUESTION PRESENTED.

During the taxable years the petitioners were engaged in the optical business. Pursuant to agreements with various eye doctors, which reflected an established and widespread industry practice, the petitioners regularly credited and paid one-third of the price received for glasses to the doctor who prescribed the glasses for the customer. The question presented is whether the amounts credited and paid to the doctors were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as ordinary and necessary expenses of doing business.

STATUTE AND REGULATIONS INVOLVED.

Internal Revenue Code:

Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

(26 U.S.C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.21-1. *Meaning of Net Income.*— . . . The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less cer-

tain credits. Although taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income....

Sec. 29.23(a)-1. *Business Expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except the classes of items which are deductible under sections 23(b) to 23(z), inclusive, and the regulations thereunder....

STATEMENT.

The petitioners are husband and wife, who in 1942, 1943 and 1944 were engaged in the optical business. As partners they owned and operated the City Optical Company, with offices in Wilmington, Fayetteville, and Greensboro, North Carolina, and in Richmond, Virginia. Petitioner Helen W. Lilly also owned and operated the Duke Optical Company in Fayetteville, North Carolina. (R. 163, 176-177.)

For many years before 1920 eye doctors or oculists customarily sold glasses to their patients. After examining the patient's eyes, the doctor would buy the necessary frame and lenses from a wholesale optician, and then resell the finished glasses to the patient. The doctor would keep the difference between the wholesale price paid to the optician and the larger retail price paid by the patient. Many doctors still do their own "dispensing," that is, they buy the lenses and frame and resell them to the patient. The physician's gain consists of a fee for services and the difference between the wholesale price and the retail price of the glasses. (R. 8, 23, 38, 41-42, 47, 69, 76, 77, 86, 111-112, 125, 179.)

In 1922, when petitioner Thomas B. Lilly organized the City Optical Company, another practice was firmly established in the optical industry. Instead of buying and re-

selling the glasses, many doctors referred their patients to designated opticians, who would directly furnish and fit the glasses, and charge the patients a retail price. Pursuant to agreement between the optician and the doctor, the former would remit a portion of the retail price to the latter. It was felt that this arrangement was superior to the other because the patient obtained better service when the optician fitted and adjusted the glasses. (R. 8, 9, 33; 47, 59, 65-66, 69, 75-76, 81, 86, 114, 125, 142-143, 176.)

The practice of making payments to doctors was widespread throughout the taxable years 1943 and 1944, as well as the intervening years after 1922. In accordance with this trade practice the petitioners paid a number of doctors one-third of the price received on the sale of glasses to their patients.[1] The petitioners would not have been able to operate successfully if they had failed to abide by this established practice. Physicians were unwilling to surrender the available differential between the wholesale and retail prices unless they were assured of the customary payments. (R. 8-10, 22-23, 33, 65-66, 69, 76, 81, 86, 107, 110-111, 114, 115, 125, 131, 176.)

The respondent determined deficiencies for 1943 and 1944 on the ground that the payments to the doctors were not deductible items. He therefore increased the petitioners' taxable income in the following amounts for the following years:[2]

Year	City Optical Company	Duke Optical Company
1942	$57,063.45	
1943	61,601.95	$6,568.87
1944	60,021.65	4,798.35

In terms of the City Optical Company's taxable income, as recomputed by the respondent, the disallowed payments

[1] In the years involved payments were made to as many as 43 physicians. (R. 168-173.)

[2] The year 1942 is involved in the calculation of tax for 1943 because of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126, Sec. 6.

exceeded 56 per cent of the Company's taxable income for 1942, 61 per cent of its taxable income for 1943, and 68 per cent of its taxable income for 1944. In terms of the Duke Optical Company's taxable income as similarly adjusted, the disallowed payments exceeded 72 per cent of the Company's taxable income for 1943 and 63 percent of its taxable income for 1944. (R. 2, 5, 161-175, 176, 179.)

The Tax Court sustained the respondent's adjustments (R. 176-196), with Judge Arundell dissenting. (R. 196-199.) The Court of Appeals affirmed the Tax Court's decision. (R. 224-229.) In the case of petitioner Thomas B. Lilly the income tax deficiencies are $54,953.67 for 1943 and $19,301.68 for 1944.[3] In the case of petitioner Helen W. Lilly the income tax deficiencies are $26,685.29 for 1943 and $23,167.14 for 1944. (R. 199-200.)

SPECIFICATION OF ERRORS TO BE URGED.

The Court of Appeals for the Fourth Circuit erred:

1. In holding that the amounts paid to the physicians were not deductible as ordinary and necessary business expenses under Section 23(a)(1)(A) of the Internal Revenue Code.

2. In holding that the amounts paid to the physicians were not deductible under Section 23(a)(1)(A) because of public policy.

3. In affirming the decision of the Tax Court.

SUMMARY OF ARGUMENT.

The sums paid to the physicians were deductible under Section 23(a)(1)(A) of the Internal Revenue Code as "ordinary" and "necessary" expenses of doing business.

A. The income tax is a levy on "net income," as distinguished from "gross income." For present purposes Section 23(a)(1)(A) defines "net income" as "gross income"

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[3] Minor portions of these deficiencies are due to issues abandoned by petitioner Thomas B. Lilly.

less "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The regulations add that "net income" is accordingly "commercial net income," determined in the light of "commercial usage." This basic principle has been reiterated and emphasized in this Court. Hence Section 23(a)(1)(A) is simply designed to assure a tax on a businessman's net accretion in wealth during the taxable year. The statute does not seek to regulate or improve trade practices and customs as they are reflected in the operating costs of a business. Nor does it seek to penalize undesirable practices and customs by disallowing the expenses which they entail and taxing more than "commercial net income."

This view of Section 23(a)(1)(A) is confirmed by the legislative history of the 1913 Act. During the Senate debate on that Act two attempts were made to disallow the deduction of "illegitimate" or "unlawful" business outlays. The proposed amendments were rejected on the ground that the only objective "is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses." The Senate deliberately rejected the effort to tax more than "actual profit during the year" for the sake of reforming "men's moral characters."

Apart from any nebulous notion of public policy, the payments to the physicians clearly qualified as deductible items under Section 23(a)(1)(A). The payments were directly connected with the petitioners' business, and they were both "ordinary" and "necessary."

B. In order to sustain his position the respondent has invoked the so-called doctrine of public policy. This doctrine is a clear departure from Section 23(a)(1)(A). Aside from its plain disregard of the language and policy of the statute, the doctrine cannot be adequately justified as a basis for denying business deductions. Both the courts and the respondent have experienced considerable difficulty in rationalizing and applying the doctrine. Even if the doctrine might properly apply where a federal statute has been

violated, it does not properly apply where local policies are involved. Section 23(a)(1)(A) was not designed to enforce canons of business behavior or professional ethics as they may variously evolve in the local courts.

C. The respondent erroneously assumes that in *Commissioner* v. *Heininger*, 320 U. S. 467 (1943), this Court approved an extra-statutory principle of public policy. In fact, there are several significant indications in the *Heininger* opinion that this Court was dissatisfied with the doctrine. Furthermore, the payments to the physicians in this case were clearly deductible under the *Heininger* decision. Here, as in the *Heininger* case, the denial of the deduction would penalize the petitioners by taxing them on "gross instead of net income."

D. Even if Section 23(a)(1)(A) is hedged by some doctrine of public policy, the payments were deductible. No federal or state statute imposed any "personal punishment" on the petitioners which a deduction might possibly "frustrate." The questioned payments had no stigma of illegality. The petitioners were not subject to any rule of law designed to deter them from making the payments. As in the *Heininger* case, the respondent has sought to attach "a serious punitive consequence" upon the petitioners which Congress did not expressly or impliedly impose. In sustaining the respondent's views, the Court of Appeals has affirmatively punished the petitioners by virtue of a rule of private law which is not aimed at them and does not attempt to punish anyone else.

E. The issue before the Court spreads far beyond this case. If the respondent may deny deductions on the basis of public policy, there is no discernible limitation upon his power to censor business outlays. Certainly the respondent does not have any modest notion of his powers of censorship. On at least two occasions he sought to disallow the deduction of "tips," and on another occasion he similarly attempted to disallow a charitable deduction. Since the respondent's principle of public policy is unconfined and elusive in content, it is inevitably harsh and retroactive in

application. In enacting Section 23(a)(1)(A) Congress did not authorize the respondent to pass upon the social desirability of business outlays and to evince his displeasure by taxing gross income.

ARGUMENT.

The Amounts Paid to the Doctors Were Deductible as Ordinary and Necessary Business Expenses Under Section 23(a)(1)(A) of the Internal Revenue Code, and the Deduction of These Amounts Was Not Prohibited by Any Principle of Public Policy.

The issue in this case is simply stated. May the respondent disallow the deduction of business expenses merely because he regards them as socially undesirable? In assuming that he enjoys this sweeping power to censor business practices, the respondent has ignored the governing statute, the related regulations, an illuminating legislative history, and principles articulated by this Court. He has also failed to remember that one should not indulge in "great thoughts about a tax problem unless the thoughts are firmly based on the controlling statute." Griswold, Cases and Materials on Federal Taxation, p. 14 (2d ed. 1946).

A. The income tax is a levy on net income. In the words of the regulations, "The normal taxes and surtaxes imposed on individuals and on corporations are computed upon net income less certain credits." As the regulations further state, "net income is a statutory conception." Regulations 111, Sec. 29.21-1. For present purposes the relevant aspects of the concept are delineated in Sections 21(a), 22(a) and 23(a)(1)(A) of the Internal Revenue Code. Section 21(a) defines "net income" as "the gross income computed under section 22, less the deductions allowed by section 23." Section 22(a) provides that "gross income" includes "gains, profits, and income" derived from "trades" and "business." Section 23(a)(1)(A) subtracts from "gross income" all "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

Section 23(a)(1)(A) is supplemented by Treasury regulations which broadly authorize the deduction of "ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business." Regulations 111, Sec. 29.23(a)-1.[4] In addition, the regulations provide that while "taxable net income is a statutory conception, it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory net income is commercial net income." Regulations 111, Sec. 29.21-1.

The same fundamental principle has been reiterated and emphasized in this Court. See *Commissioner* v. *Heininger*, *supra*, at 474. For Section 23(a)(1)(A) assures the deduction of "outlays in the efforts or services" from which "income flows." Frankfurter, J., in *McDonald* v. *Commissioner*, 323 U. S. 57, 60-61 (1944). "Taxation on net, not on gross, income has always been the broad basic policy of our income tax laws. Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it." Black, J., *id.* at 66-67. See also *id.* at 68-69; and Roberts, J., in *Deputy* v. *du Pont*, 308 U. S. 488, 500 (1940).

By the same token Section 23(a)(1)(A) is not an essay in morality, designed to encourage virtue and to discourage sin. The provision is more modestly concerned with "commercial net income"—a businessman's net accretion in wealth during the taxable year. The statute does not attempt to regulate or improve trade practices and customs as they are reflected in the operating costs of a business.[5]

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[4] The regulations specifically exclude federal tax penalties from the realm of business deductions. But cf. *Greene Motor Co.*, 5 T. C. 314 (1945), which relies on *Commissioner* v. *Heininger*, 320 U. S. 467 (1943).

[5] Of course, within constitutional limitations Congress may use the tax laws for vital non-fiscal purposes. However, in enacting Section 23(a)(1)(A) Congress was not motivated by such objectives. And where Congress has wished to deny tax deductions as a

Nor does it attempt to penalize undesirable practices and customs by disallowing the expenses which they entail and taxing more than "commercial net income." On the contrary, Section 23(a)(1)(A) accepts and applies trade practices and customs in measuring the net profit of an enterprise.

If, for some reason, the text and context of Section 23(a)(1)(A) leave any doubt in this regard, the doubt should be fully dispelled by the legislative history of the 1913 Act. That Act, which introduced our modern income tax system, similarly granted a deduction for business expenses. 1913 Act, Sec. II(A) and (G)(b). During the debate on that Act the issue here involved was squarely posed and resolved. The legislative discussion clearly indicates that in authorizing a deduction for business outlays, Congress did not seek to police, prohibit or punish trade practices by withholding tax deductions.[6]

The bill, as reported by the Senate Finance Committee, granted individuals a deduction for the "necessary expenses actually paid in carrying on any business," and accorded corporations a similar deduction for "all the ordinary and necessary expenses paid within the year in the maintenance and operation" of their "business and properties." The same section authorized individuals to deduct "losses actually sustained during the year, incurred in trade," and permitted corporations to deduct "all losses

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means of reinforcing the sanctions of other federal statutes, it has explicitly so provided. See Section 5(a), Stabilization Act of 1942, 56 Stat. 767 (1942), 50 U. S. C. A. App. § 965 (a); Defense Production Act of 1950, § 405 (b), 64 Stat. 807 (1950), 50 U. S. C. A. App. § 2105; Defense Production Act Amendments of 1951, Pub. L. No. 96, 82d Cong., 1st Sess. § 104(i) (1951).

[6] As this Court has often recognized, an informed Congressional discussion of pending legislation is highly relevant in determining the policy and scope of a statute. *Helvering* v. *Griffiths*, 318 U. S. 371, 380-387 (1943); *United States* v. *Lovett*, 328 U. S. 303, 308-310 (1946); *United States* v. *Congress of Industrial Organizations*, 335 U. S. 106, 115 (1948).

actually sustained within the year." Seidman, Legislative History of Federal Income Tax Laws, 1938-1861, pp. 992, 995 (1938). Senator Sterling felt quite strongly that the bill was too generous. Hence he proposed that it be "qualified by some expression as 'losses incurred in legitimate and ordinary trade pursued by the party,' or equivalent words." 50 Cong. Rec. 3849 (1913).[7] Senator Williams, a ranking member of the Finance Committee who was in charge of the income tax provisions of the bill,[8] vigorously opposed the proposal:

> "Mr. Williams. Mr. President, the object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way." *Ibid.*

Thereafter the following discussion took place:

> "The Secretary. On page 169, line 15, it is proposed to strike out the words 'in trade' and insert 'by the taxpayer in the pursuit of any ordinary and legitimate trade or business.'
>
> "Mr. Sterling. If the amendment were adopted, the provision would read:
>
> "Losses incurred by the taxpayer in the pursuit of any ordinary and legitimate trade or business.
>
> "Mr. Williams. In other words, you are going to count the man as having money which he has not got,

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[7] Though Senator Sterling's amendment dealt with "losses," the discussion which followed disclosed a controlling philosophy which encompassed all deductions for business outlays, whether technically "losses" or "expenses."

[8] See Blakey, The Federal Income Tax, p. 87 (1940); Ratner, American Taxation, p. 330 (1942).

because he has lost it in a way that you do not approve of.

"Mr. Sterling. And I think rightly so.

"Mr. Smoot. Mr. President, I should like to ask the Senator what becomes of the man who is a broker and whose whole business is dealing upon the stock exchange? Does the Senator think that he ought to be taxed upon his income; and, if so, should not that man be allowed to deduct whatever loss he may incur in that particular line of business?

"Mr. Sterling. I think so, because I think the business of the broker, as a general proposition, is a legitimate business; but the amendment would exclude losses sustained in stock and grain gambling; that is the idea.

"Mr. Smoot. The Senator differentiates, then, between the broker who does nothing else but follow that business and the man who does it 'on the side'?

"Mr. Sterling. Oh, no. A man may occasionally engage in the brokerage business, and, taking a particular deal, it may be perfectly honest and legitimate; or he may be a regular broker engaged continuously in a business which is legitimate. My only object in suggesting this amendment is to prevent, if it can be done, what might be termed the setting off of a loss in a strictly gambling operation.

"Mr. McCumber. Let me ask the Senator a question right there. If the successful party in the gambling operation—and I always supposed that what one man loses the other man gains in a straight gambling contract—makes $10,000, would not the Senator charge it up to him as taxable income?

"Mr. Sterling. I do not know but that I would; and I do not think there would be any injustice or wrong in doing so.

"Mr. McCumber. Very well. Then, if the Senator taxes him once upon that, why should he seek to tax that same $10,000 twice, both to the man who lost it and to the man who gained it?

"Mr. Sterling. The same supposition might be made in other cases, so far as that is concerned. You do not always avoid double taxation.

"The amendment was rejected." *Id.* at 3850.[9]

Despite his defeat Senator Sterling tried once more:

"THE SECRETARY. The Senator from South Dakota [Mr. Sterling] * * * now proposes the following amendment: On page 169, line 15, insert the word 'lawful' after the word 'in' and before the word 'trade,' so as to read:

"Incurred in lawful trade or arising from fires, storms, or shipwreck, etc.

"MR. STERLING. Mr. President, I simply wish to say that this amendment is in form somewhat different to the one I offered in Committee of the Whole. That amendment referred to losses that might be sustained in legitimate or ordinary trade. I hardly think those were the apt and exact words to be used in this connection, but the word 'lawful' is better. It is the purpose of the amendment simply to prevent a claim for losses or a deduction of losses arising out of a trade or a business carried on in violation of law.

* * *

"The amendment to the amendment was rejected." *Id.* at 4613.

In view of this revealing legislative discussion, the Court of Appeals clearly erred in disallowing the deduction of the payments made to the doctors. To borrow the words of Sentor Williams, the respondent has rejected the deduction because the outlays were made "in a way" which the respondent did "not approve of." Although the sole "object" of Section 23(a)(1)(A) "is to tax a man's net income"—"his actual profit during the year"— the respondent has assumed that the provision was designed "to reform men's moral characters." As a result the respondent has naturally imposed a tax on far more than "net income," which consists of "receipts" less "expenditures."[10] And

[9] Senators McCumber and Smoot were both members of the Finance Committee, and later each became Chairman of the Committee.

[10] See pp. 11-12, *supra*.

in taxing much more than "net income" or "actual profit," the respondent has necessarily penalized the petitioners because of business outlays which were easily "ordinary" and "necessary." At the same time, as Senator McCumber remarked, the respondent has zealously taxed the same sum "twice, both to the man who lost it and to the man who gained it."

Indeed, in approving the respondent's strange views on "net income," the Court of Appeals tacitly conceded that the payments to the physicians satisfied the requirements of Section 23(a)(1)(A). Otherwise the Court would not have invoked the so-called doctrine of public policy.[11] Certainly the concession was clearly required unless the opinions of this Court were to be ignored.

This Court has held that an outlay is a business expense if it "is directly connected with" or "proximately resulted from" the taxpayer's business. *Kornhauser* v. *United States*, 276 U. S. 145, 153 (1928). See further *Trust of Bingham* v. *Commissioner*, 325 U. S. 365, 373-374 (1945). This Court has also declared that an expense is "ordinary" if it is "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," or "embraced within the normal overhead or operating costs" of the enterprise. An "extremely relevant" consideration "is the nature and scope of the particular business out of which the expense in question accrued." *Deputy* v. *du Pont, supra*, at 495-496. Or as previously stated in *Welch* v. *Helvering*, 290 U. S. 111 (1933), in determining what is ordinary, "we have recourse to any fund of business experience, to any known business practice." "The standard set up by the statute is not a rule of law; it is rather a way of life." Hence our guide is "the ways of conduct and the forms of speech prevailing in the business world." *Id.* at

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[11] The Tax Court put the matter quite bluntly. The payments, it declared, "are not deductible as ordinary and necessary expenses because the contracts under which these payments were made violated public policy." (R. 196.)

114, 115. Finally, this Court has held that an expense is "necessary" if it is "appropriate and helpful" in the conduct of the business concerned. *Id.* at 113. See also *Commissioner* v. *Heininger, supra;* at 471. Cf. *Commissioner* v. *Flowers,* 326 U. S. 465, 470 (1946).

Obviously, the sums paid by the petitioners were "directly connected" with their business. The payments were intimately related not only to the business, but to the production of income for the business. Cf. *Trust of Bingham* v. *Commissioner, supra,* at 373-374. They were certainly "ordinary," since they were "normal, usual, or customary," "of common or frequent occurrence in the type of business involved," and included in "the normal overhead or operating costs" of the business. In making the payments the petitioners simply conformed to "the ways of conduct" of the "particular business" in which they were engaged. And the payments easily qualified as "necessary."[12] In fact, they were more than merely "appropriate and helpful." The payments were unavoidable if the petitioners were to compete successfully in an industry where the custom of making payments was firmly entrenched through no choice of their own. In short, the amounts paid to the physicians fell well within Section 23(a)(1)(A).

B. As this Court succinctly observed in *Commissioner* v. *Heininger, supra,* at 473, the so-called doctrine of public policy has "narrowed the generally accepted meaning of the language used in § 23(a)." The doctrine is admittedly "a judicial gloss" (*Jerry Rossman Corporation* v. *Commissioner,* 175 F. 2d 711, 713 (C. A. 2, 1949)), for "neither the tax statute nor the treasury regulations condition deductibility upon the lawful character, either directly or remotely, of the expenditures made." *National Brass Works*

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[12] As regards the "necessity" of a business expense, this Court has stated that "we should be slow to override" the taxpayer's "judgment." See *Welch* v. *Helvering, supra,* at 113.

v. *Commissioner*, 182 F. 2d 526, 530 (C. A. 9, 1950).[13] Under "the broad definition of gross income, income arising from an illegal business is taxed even though the illegality be one declared by the Constitution itself . . . . The provisions of the statute fixing the deductions to be regarded in arriving at the net income which alone is taxed . . . are as broad and unqualified as those defining the taxable gross income." *Alexandria Gravel Co.* v. *Commissioner*, 95 F. 2d 615, 616 (C. A. 5, 1938). See also Minton, J., *Heininger* v. *Commissioner*, 133 F. 2d 567, 569 (C. A. 7, 1943). Apart from its disregard of the statute, the doctrine of public policy is one of those curious principles which are more easily invoked than justified. Though the doctrine has, of course, been rationalized from time to time, the reasons have not improved with age. Indeed, age has disclosed increasing blemishes.

Generally speaking, the doctrine has been applied in three areas. In the first place, penalties incurred in the course of business have been disallowed as deductions. See, *e.g.*, *Great Northern Railway Co.* v. *Commissioner*, 40 F. 2d 372 (C. A. 8, 1930), *cert. denied*, 282 U. S. 855 (1930); *Burroughs Building Material Co.* v. *Commissioner*, 47 F. 2d 178 (C. A. 2, 1931); *Chicago, Rock Island & Pacific Railway Co.* v. *Commissioner*, 47 F. 2d 990 (C. A. 7, 1931), *cert. denied*, 284 U. S. 618 (1931); *Commissioner* v. *Longhorn Portland Cement Co.*, 148 F. 2d 276 (C. A. 5, 1945), *cert. denied*, 326 U. S. 728 (1945). But cf. *Huff, Andrews & Thomas*, 1 B. T. A. 542 (1925). Secondly, legal expenses have been similarly disallowed where they were incurred in contesting the imposition of a penalty or other public sanction and the defense was unsuccessful. See, *e.g.*, *Burroughs Building Material Co.* v. *Commissioner*, *supra*; *National Outdoor Advertising Bureau* v. *Helvering*, 89 F. 2d 878

[13] The present case does not turn on the validity and application of any regulation in which the respondent has sought to define the statutory words "ordinary" and "necessary." See *Commissioner* v. *Heininger*, *supra*, at 470.

(C. A. 2, 1937); *Helvering* v. *Superior Wines & Liquors*, 134 F. 2d 373 (C. A. 8, 1943).[14] Thirdly, political bribes and commercial extortions have also been disallowed. See, *e.g.*, *Rugel* v. *Commissioner*, 127 F. 2d 393 (C. A. 8, 1942); *Kelley-Dempsey & Co.*, 31 B. T. A. 351 (1934); *T. G. Nicholson*, 38 B. T. A. 190 (1938). But cf. *Alexandria Gravel Co.* v. *Commissioner*, *supra*, where no undue influence was found, which was cited approvingly in *Heininger* v. *Commissioner*, *supra*, at 569.

Since the decisions on "public policy" have wandered well beyond the statute, the courts have not found it easy to explain the reasons for the results. Undoubtedly "the judicial function in construing legislation is not a mechanical process from which judgment is excluded." But it is equally true that the judicial function is "very different from the legislative function." "To let general words draw nourishment from their purpose is one thing. To draw on some unexpressed spirit outside the bounds of the normal meaning of words is quite another." *Addison* v. *Holly Hill Co.*, 322 U. S. 607, 617-618 (1944). This admonition is especially appropriate here. For in seeking to apply a doctrine of public policy in the realm of business expenses the courts have simply called upon "some unexpressed spirit" far removed from the language and policy of Section 23(a)(1)(A). Under the circumstances the opinions are unavoidably unsatisfactory. And the difficulties which nourish their inadequacies "can neither be met nor avoided by spurious interpretation of tax provisions dealing with allowable deductions." *McDonald* v. *Commissioner*, *supra*, at 63.

Three decisions sufficiently illustrate a few of the inescapable difficulties. In *Great Northern Railway Co.* v. *Commissioner*, *supra*, the taxpayer sought to deduct penalties which had been assessed for violations of the Safety Ap-

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[14] In *Commissioner* v. *Heininger*, *supra*, this Court granted certiorari because of an alleged conflict with the decisions in the *National Outdoor* and the *Superior Wines* cases. See 320 U. S. at 470.

pliances Act[15] and the Hours of Service Law.[16] The Eighth Circuit agreed that the expenses "arose in connection with the operation of the road." But, the Court concluded, it "cannot be" that Congress intended to reduce the penalties by means of a tax deduction. 40 F. 2d at 373. In *Burroughs Building Material Co. v. Commissioner, supra,* the taxpayer had paid a state fine after pleading guilty to an indictment for price fixing. The Second Circuit disallowed the deduction of the fine. The Court reasoned that the fine had no "necessary" connection with the business and refused "to sanction expenditures of such a character as we have here on grounds of public policy." 47 F. 2d at 180. Later the Second Circuit reappraised the doctrine of public policy in *National Outdoor Advertising Bureau v. Helvering, supra,* which involved legal expenses incurred in an anti-trust proceeding. In denying the deduction of the expenses the Second Circuit justified the doctrine on the ground that it "is never necessary to violate the law in managing a business." 89 F. 2d at 881.

The varying explanations which appear in these cases hardly survive analysis. For example, to argue that a penalty is "unnecessary" is to ignore the context in which Section 23(a)(1)(A) functions. In our increasingly complex society, swarming with rules and regulations, legal differences with the Government have become an ordinary, everyday hazard of doing business. It has become the business of businessmen to find their way, as best they can, through "the daedalian mazes" of statutes, decisions, directives, instructions and forms. Cf. *Jerry Rossman Corporation v. Commissioner, supra,* at 714. Amid the flourishing "thickets of verbiage" words frequently dance before the eye "in a meaningless procession," leaving "only a confused sense of some vitally important, but successfully concealed, purport." Hand, *Thomas Walter Swan,* 57 Yale L. J. 167, 169 (1947). Violations are inevitable though in-

[15] 36 Stat. 299 (1910), 45 U. S. C. A. § 13.

[16] 39 Stat. 722 (1916), 45 U. S. C. A. § 66.

tentions are the most honorable. Errors in good faith are to be expected and expectations are repeatedly justified. If judges, administrators and lawyers so often disagree, laymen should scarcely do better. To put the matter in a nutshell, "there are 'penalties' and 'penalties.'" *Jerry Rossman Corporation* v. *Commissioner, supra,* at 713. While not all are practically unavoidable, a good many unfortunately are. And so even courts which have disallowed the deduction of penalties have abandoned a wooden rule which would bar the deduction in all cases. They have come to realize that penalties incurred in good faith in the ordinary course of business represent the normal cost of doing business. See *Jerry Rossman Corporation* v. *Commissioner, supra* (alternative ground for decision); *National Brass Works* v. *Commissioner, supra.* Cf. I. T. 3530, C. B. 1942-1, p. 43.

If penalties for wrongdoing are "unnecessary," so are outlays caused by torts. Nevertheless the courts have repeatedly held that a taxpayer may deduct damages paid to a private person because of a wrong committed in the operation of a business. They have considered it immaterial whether the injury was caused by negligence, conspiracy, misrepresentation, conversion, or violation of a statute. See *Becker Bros.* v. *United States,* 7 F. 2d 3 (C. A. 2, 1925)—infringement of patent; *Helvering* v. *Hampton,* 79 F. 2d 358 (C. A. 9, 1935)—fraud; *Anderson* v. *Commissioner,* 81 F. 2d 457 (C. A. 10, 1936)—negligence resulting in death; *H. M. Howard,* 22 B. T. A. 375 (1931)—misrepresentation and conspiracy; *W. R. Hervey,* 25 B. T. A. 1282 (1932)—violation of usury laws; *International Shoe Co.,* 38 B. T. A. 81 (1938)—conspiracy; *Robert S. Farrell,* 44 B. T. A. 238 (1941)—unlawful acts as director; *William Ziegler, Jr.,* 5 T. C. 150 (1945)—mismanagement of corporation; *Dixon Fagerberg,* 1942 P.-H. B. T. A. Memo. Dec. ¶ 42,091—conversion of corporate assets.[17] In *Helvering* v. *Hampton, supra,* at 360, the Court of Appeals for the

[17] See further O. D. 978, C. B. 5, p. 135 (1921); I. T. 3627, C. B. 1943, p. 111; I. T. 3762, C. B. 1945, p. 95.

Ninth Circuit stated, "We cannot agree that private wrongdoing in the course of business is extraordinary within the meaning of the taxing statute allowing deductions for ordinary and necessary expenses. The statute itself makes no such exception . . . . "[18] See also *Anderson* v. *Commissioner, supra*, at 460. If "private wrongdoing" in business is not "extraordinary," we fail to understand why "public wrongdoing" always is.

The decisions relating to private wrongs are relevant in another connection. As indicated, the argument has been made that the deduction of a penalty would, in effect, "reduce" or "mitigate" the sanction. But the deduction of damages imposed because of a private transgression similarly "reduces" or "mitigates" the sanction imposed upon a taxpayer for his wrongful conduct. It is not surprising that on other occasions the respondent has disparaged any distinction between penalties and damages, and has contended that both are equally non-deductible. See, *e.g.*, *Helvering* v. *Hampton, supra*, at 359; *International Shoe Co.*, *supra*, at 95. In both cases "public policy" is equally involved and equally violated.

The Second Circuit has frankly confessed that unless "an arbitrary line" is drawn, it is difficult to reconcile the decisions which allow the deduction of outlays deriving from a "private" wrong with the decisions which deny the deduction of outlays deriving from a "public" wrong. *Burroughs Building Material Co.* v. *Commissioner, supra*, at 180. After pointing out that fines may be "not infrequent" and "inevitable," the Court stated, "It is not easy to distinguish such fines from expenditures incurred in connection with actions to recover for negligence or because of

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[18] In the *Heininger* case this Court seems to have approved the *Hampton* decision. See 320 U. S. at 472, n. 6. Cf. *Kornhauser* v. *United States, supra*; *Foss* v. *Commissioner*, 75 F. 2d 326 (C. A. 1, 1935); *Isaac P. Keeler*, 23 B. T. A. 467 (1931); *William A. Falls*, 7 T. C. 66 (1946). But cf. *National Outdoor Advertising Bureau* v. *Helvering, supra*, at 881.

patent infringements, unless one draws an arbitrary line between criminal and civil actions even where the criminal actions relate to matters involving no moral turpitude. Undoubtedly expenditures which are in themselves immoral, such as for bribery of public officials to secure protection of an unlawful business would not have to be allowed in order consistently to justify a deduction of fines paid for violations of law involving no moral turpitude and practically inevitable."[19] See further Note, 54 Harv. L. Rev. 852, 856 (1941).

Even if a doctrine of public policy might in some cases properly apply where a federal statute has been violated, the doctrine is surely an "alien intruder" where state statutes and other indicia of local policy are involved. As this Court has "often had occasion to point out, the revenue

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[19] The Court evidently felt that such payments as bribery of public officials do not qualify as outlays "ordinarily" made, quite apart from any extra-statutory concept of public policy, and that the disallowance of such expenses could well be placed on that statutory ground. See also *Alexandria Gravel Co.* v. *Commissioner*, *supra*, at 616; *Excelsior Baking Co.* v. *United States*, 82 F. Supp. 423, 428 (D. Minn. 1949); *Kelley-Dempsey & Co.*, *supra*, at 354; and 4 Mertens, The Law of Federal Income Taxation, § 25.35 (1942). The term "ordinary" is not free from ambiguity at the outer edges. Hence the Treasury may apparently define "ordinary" in a particular area of expenditure by a reasonable exercise of its rule-making power. For example, in *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326 (1941), this Court sustained a regulation which excluded lobbying expenses from the concept of "ordinary and necessary." The regulation is probably extreme in a number of cases, since there are industries where legislative activity is quite "ordinary." However, though in various instances "the factual situation will be so extreme as to leave no doubt," this Court recognized that "the nuances of facts between the two extremes have produced a nebulous field of confusion which has been recognized by courts striving to fit close cases into one category or the other." And "interpretative regulations" are "appropriate aids toward eliminating that confusion and uncertainty." See *Magruder* v. *Realty Corp.*, 316 U. S. 69, 73-74 (1942), referring to the *Textile Mills* decision.

laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application." *United States* v. *Pelzer,* 312 U. S. 399, 402 (1941). "Were it not so, federal tax legislation would be the victim of conflicting state decisions on matters relating to local concerns and quite unrelated to the single uniform purpose of federal taxation." *Estate of Rogers* v. *Commissioner,* 320 U. S. 410, 414 (1943). We need hardly add that "the single uniform purpose" of Section 23(a)(1(A) is not directed toward the enforcement of "the peculiarities and special incidences" of local policies. Cf. *Lyeth* v. *Hoey,* 305 U. S. 188, 193 (1938). That purpose, rather, contemplates a tax on business income after allowance for all business expenses which are "ordinary" and "necessary" according to "the ways of conduct and the forms of speech prevailing in the business world." *Commissioner* v. *Heininger, supra,* at 472.

The respondent's understanding of Section 23(a)(1)(A) simply disregards its clear purport and plain function. This provision "was not contrived as an arm of the law to enforce State criminal statutes by augmenting the punishment which the State inflicts."[20] Nor was this provision contrived to enforce canons of business behavior or professional ethics as they may variously evolve in the state courts. Certainly there is no indication that the respondent's agents are particularly skilled in the art of regulating trade practices as distinguished from the art of computing and collecting taxes.

In so far as Section 23(a)(1)(A) is concerned, the basic policy of Congress is well beyond the pale of doubt. The sole objective of Section 23(a)(1)(A) is to confine the burden of the income tax to net income. "The purpose here is to tax earnings and profits less expenses and losses. If one or the other factor in any calculation is unreal, it dis-

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[20] Member Sternhagen, dissenting in *Burroughs Building Material Co.,* 18 B. T .A. 101, 105 (1929).

torts the liability of the particular taxpayer to the detriment or advantage of the entire tax paying group." *Higgins* v. *Smith*, 308 U. S. 473, 477 (1940). The respondent's reliance on some notion of public policy, above and beyond Section 23(a)(1)(A), is mere question begging. To borrow Mr. Justice Holmes' memorable phrase, the public policy of taxation is not "a brooding omnipresence in the sky" (*Southern Pacific Co.* v. *Jensen*, 244 U. S. 205, 222 (1917)) whose aid the respondent may periodically invoke as he sees fit. The public policy of taxation is the policy which Congress creates, and that policy is expressed in the taxing provisions which Congress has enacted.

C. The respondent apparently assumes that in *Commissioner* v. *Heininger*, *supra*, this Court approved some extra-statutory principle of public policy forbidding the deduction of outlays which are otherwise well within the language of Section 23(a)(1)(A). Evidently the respondent is more confident in this regard than the Second Circuit. See *Jerry Rossman Corporation* v. *Commissioner*, *supra*, at 713. In the *Heininger* case this Court observed that "The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in Section 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct." 320 U. S. at 473. In making this observation, the Court hardly endorsed by indirection any vague doctrine of public policy as a criterion of deductibility for tax purposes. The Court merely indicated, we believe, that even the nebulous notion of public policy, which lower courts had at times approved, did not bar the particular deduction in controversy. See *id.* at 475.

There are several indications in the *Heininger* opinion that this Court was dissatisfied with the doctrine of public policy. To begin with, the opinion pointedly noted that the doctrine "narrowed the generally accepted meaning of the

language used in Section 23(a)." In the same connection the opinion explicitly stated that "the language of Section 23(a) contains no express reference to the lawful or unlawful character of the business expenses which are declared to be deductible." And the opinion then declared that the tax laws do not "penalize illegal business by taxing gross instead of net income." *Id.* at 474. Clearly this statement rejects any vagrant principle of public policy. For under any such theory illegal business should not be allowed any deductions on the ground that deductions aid and encourage taxpayers to engage in unlawful activities. Cf. Minton, J., in *Heininger* v. *Commissioner, supra,* at 570.[21] Moreover, if the *Heininger* decision approved the doctrine of public policy, it did so by disapproving a very substantial portion of that doctrine. Previously it had been held that a taxpayer could not deduct legal expenses incurred in an unsuccessful effort to forestall a penalty or other public sanction. See *Jerry Rossman Corporation* v. *Commissioner, supra,* at 713; and cases cited at pp. 16-17, *supra.* As a result of the *Heininger* opinion the Treasury has finally abandoned this view. See, *e.g.,* G. C. M. 24377, C. B. 1944, p. 93; G. C. M. 24810, C. B. 1946, p. 55.

The petitioners' payments to the physicians were plainly deductible under the *Heininger* decision. As the *Heininger* opinion indicates, the denial of the deduction would render the petitioners taxable on "gross instead of net income;" and a tax on gross income would necessarily "penalize" the petitioners, although Section 23(a)(1)(A) was not designed to punish taxpayers. In summarizing the scope of the *Heininger* decision as it applies here, we cannot do

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[21] In the case of an illegal business it is scarcely possible to draw a neat distinction between "legitimate" and "illegitimate" expenses. All are equally dedicated to the successful operation of the illegal enterprise. But cf. *G. A. Comeaux,* 10 T. C. 201, 207 (1948), *aff'd,* 176 F. 2d 394 (C. A. 10, 1949), which states that the "distinction may at first seem nebulous," but "is nonetheless real."

better than quote from Judge Minton's opinion in the same case for the Court of Appeals for the Seventh Circuit: "If the deduction in the case at bar was not an ordinary and necessary expense to the 'carrying on' of the business, we are unable to understand the English language. Without this expense, there would have been no business. Without the business, there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary." *Heininger v. Commissioner, supra*, at 570.

D. Even if the meaning of Section 23(a)(1)(A) is mysteriously hedged by some doctrine of public policy, the Court of Appeals erred in denying the deduction of the payments to the physicians.

In *Commissioner v. Heininger, supra,* the taxpayer was a dentist who made and sold false teeth in a mail order business. The Postmaster General issued a fraud order against him on the ground that his statements tended to mislead prospective customers or to misrepresent the quality of his product. The taxpayer sought an injunction against the fraud order, but his efforts ultimately failed. During the litigation he incurred lawyer's fees and related legal costs, which he later deducted in computing his federal income taxes. As in the present case, the Commissioner strenuously argued that Section 23(a)(1)(A) does not sanction any deduction which contravenes public policy. This Court rejected the argument for reasons which equally apply here and which the Court of Appeals misunderstood.

If the outlays "are to be denied deduction," the Court stated, "it must be because allowance of the deduction would frustrate the sharply defined policies" of the postal statutes "which authorize the Postmaster General to issue fraud orders. The single policy of these sections is to protect the public from fraudulent practices committed through the use of the mails. It is not their policy to impose personal punishment on violators; such punishment is pro-

vided by separate statute, and can be imposed only in a judicial proceeding in which the accused has the benefit of constitutional and statutory safeguards appropriate to trial for a crime."[22] Hence it followed "that to allow the deduction" of the expenses "would not frustrate the policy of these statutes; and to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding." *Id.* at 474-475.

The reasoning of this Court in the *Heininger* case peculiarly applies here. No federal or state statute imposed any "personal punishment" on the petitioners because of their payments to physicians. For that matter the petitioners, unlike the taxpayer in the *Heininger* case, were not subject to any statute or rule of law designed to deter them from the questioned business practice.[23] The payments had not the remotest stigma of illegality.[24] In denying the deduction the Court of Appeals necessarily attached "a serious punitive consequence" upon the petitioners where none was otherwise imposed upon them. The Tax Court has candidly conceded that "the effect" of its decision in this case "was to penalize the optician." *See Weather-Seal Manufacturing Co.,* 16 T. C. No. 158 (1951).

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[22] The opinion further stated that the postal statutes were not designed to deter alleged offenders from employing counsel in defense against fraud orders.

[23] States which frowned on the practice expressed their disapproval by legislation imposing penalties. See California Business and Professional Code (Deering, 1949 Pocket Supp.) §§ 650, 652; Remington's Revised Statutes of Washington, Annotated (1949 Supp.) § 10185-14. This year North Carolina also imposed a penalty for the first time. See General Statutes of North Carolina (Supp. 1951) § 90-255.

[24] Cf. I. T. 1853, C. B. II-2, pp. 124, 125 (1923), which, in allowing a deduction, distinguished between an "illegal transaction"—"something falling within the prohibition of positive enactment"—and a breach of equitable duty.

The Court of Appeals reasoned that the agreements between the petitioners and the physicians were contrary to public policy because the rebates violated the fiduciary responsibility of the physicians to their patients. The alleged violation consisted of the doctor's "secret profits through dealings with his patients." (R. 228.)[25] If we extend the utmost credit to this reasoning, the Court of Appeals merely established that the agreements were contrary to public policy in the sense that a physician would not be able to recover upon them. Cf. *Reilly* v. *Beekman*, 24 F. 2d 791 (C. A. 2, 1928), on which the Court of Appeals relied. The rule of law implicit in the physician's inability to recover is exclusively directed against the physician and is solely designed to prevent him from collecting the promised payment. The rule does not even attempt "to impose personal punishment" on the physician. On no theory would the doctor's inability to enforce payment be deemed a penalty for an unlawful act. At worst the physician would be deprived of a profit to which he was not entitled. See *Jerry Rossman Corporation* v. *Commissioner, supra,* at 712. In disallowing the deduction of the payments, the Court of Appeals affirmatively punished the petitioners by virtue of a rule of private law which is not at all aimed at them and does not purport to punish anyone else. In short, the petitioners have been punished because the doctors allegedly misbehaved.

In *Jerry Rossman Corporation* v. *Commissioner, supra,* the Court of Appeals for the Second Circuit held that under the *Heininger* decision fines and forfeitures are deductible, depending "upon the place of sanctions in the scheme of enforcement of the underlying act." The Court expressly rejected any rigid rule that a taxpayer may not deduct payments resulting from a violation of statute or

[25] There is no question of tax avoidance here. The physicians regularly reported the petitioners' payments as taxable income. (R. 28, 40, 59-60, 76, 137, 143, 148, 153-154, 159.) The respondent is attempting to tax the same amounts as income to the petitioners.

some other manifestation of policy. 175 F. 2d at 713. Instead the Court held that a penalty is deductible as long as the allowance does not "frustrate" any "sharply defined policies" of the act imposing the penalty. In this case, unlike the *Rossman* case, no "sanction" whatever was imposed upon the petitioners which the deduction could conceivably frustrate. In fact, the petitioners were not even subject to the slightest "scheme of enforcement."

The decision of the Court of Appeals in this case nicely exemplifies the endless confusion which the principle of "public policy" inevitably breeds.[26] The Court of Appeals did not deny that the questioned payments, apart from public policy, qualified as ordinary and necessary business expenses. However, the Court concluded that the payments were not deductible because they failed to satisfy the standards of equity as compared with the standards of the market place. In support the Court quoted Mr. Justice Cardozo's famous admonition that many "forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon,* 249 N. Y. 458, 464, 164 N. E. 545, 546 (1928). This quotation leaves no doubt of the Court of Appeals' confusion. The present controversy is not a suit

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[26] The Treasury is by no means immune to the confusion. See, for example, its vacillating views on the deductibility of truckers' fines, as reflected in P.-H. 1950 Fed. Tax Serv., ¶ 76,321, and I. T. 4042, C.B. 1951-1, p. 15. And see the twists and turns related in G. C. M. 23438, C. B. 1942-2, p. 188. Nor have the courts been free from confusion. As instances, compare the Tax Court's views with those of the Fifth Circuit in *Longhorn Portland Cement Co.,* 3 T. C. 310 (1944), *rev'd in part,* 148 F. 2d 276 (C.A. 5, 1945); and the Tax Court's views with those of the Eighth Circuit in *Helvering v. Superior Wines & Liquors,* 134 F. 2d 373 (C. A. 8, 1943), *rev'g* 1941 P.-H. B. T. A. Memo. Dec. ¶ 41,364. See further the varying attitudes in *Greene Motor Co., supra.*

in equity, nor was Section 23(a)(1)(A) devised as a means of enforcing the sensitive standards of equity. That provision simply authorizes deductions from gross income in accordance with "the ways of conduct" in "the business world." *Welch* v. *Helvering, supra,* at 115; *Commissioner* v. *Heininger, supra,* at 471. In its anxiety to apply a principle of equity, wholly unrelated to federal taxation, the Court of Appeals overlooked the language and policy of Section 23(a)(1)(A).[27] Just as the allowance of deductions under that provision does not depend upon "equitable considerations" (*Deputy* v. *du Pont, supra,* at 493), neither does their denial.[28]

In an effort to sustain his conclusion, the respondent has sought to envelop the petitioners in an atmosphere of evil and corruption which he apparently attributes to them. As the petitioners have stated and as the record clearly re-

[27] Cf. *Burnet* v. *Guggenheim,* 288 U. S. 280, 289 (1933): "A transfer within the meaning of a taxing act may or may not be one within the statute of Elizabeth."

[28] The Court of Appeals' opinion additionally indicates that "public policy" easily leads into a quagmire of abstract assumptions divorced from relevant fact. The opinion argued that the agreements between the petitioners and the physicians were unenforceable because they tended to corrupt the latter into prescribing unnecessary or unduly expensive glasses, recommending an inferior optician, and artificially increasing the price of glasses. However, the record provides no evidentiary basis for this conclusion. It is a speculation rather than a finding. Cf. *F. L. Bateman,* 34 B. T. A. 351, 367 (1936), where, in analogous circumstances, the Board of Tax Appeals refused to assume corruption in the absence of evidence to that effect. Again, the practice of payments to physicians no more corrupted them than the other custom whereby they lawfully purchase glasses at a wholesale price and resell them at a retail price. Nor is the physician who receives a payment from an optician more tempted to do what the Court of Appeals feared than the physician who runs his own optical business and therefore has a potential financial stake in prescribing glasses. All these considerations sharply underscore the futility of using Section 23(a)(1)(A) as a means of policing the integrity of eye doctors.

veals,[29] payments to doctors reflected a settled industry practice when the petitioners entered the optical field.[30] To suggest that the petitioners initiated a policy of corrupting physicians is to indulge in naive imagination. In 1941 the Chairman of the Section on Ophthalmology of the American Medical Association frankly declared that doctors were generally oblivious to any professional standards on the subject. The standards were "more 'honor'd in the breach than in the observance.'"[31] Needless to say, the petitioners would have been very glad to retain the sums paid to the doctors if competitive conditions had permitted them to do so.[32]

The various medical resolutions and editorials quoted by the respondent graphically indicate that the custom of

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[29] See pp. 3-4, *supra*.

[30] The respondent has not denied that the evidence to this effect is clear and uncontradicted. Instead he has resorted to the frail excuse that the evidence consists of "statements, often self-serving, of various witnesses." (Resp. Brief In Opposition to Pet. for Certiorari, p. 15.) The evidence in question was direct oral testimony subject to the usual safeguards provided by cross-examination.

[31] Snell, *Some Principles of Medical Ethics Applied to the Practice of Ophthalmology*, 117 The Journal of the American Medical Association, 497, 498 (1941).

[32] The respondent has pointed out that a competitor of the petitioners discontinued the same practice *after* the taxable years in question. (Resp. Brief in Opposition to Pet. for Certiorari, p. 8.) This competitor was the American Optical Company, which, the Government charged in 1946, was paying rebates to about 3,000 physicians. (R. 165, 172.) A survey in 1940 showed that since "the optician depends completely on the good favor of the eye physician, he must take pains to avoid irritating either the physician or his patients." In Chicago alone it was estimated that "90 to 99 per cent of all eye physicians" not only accept payment, "but that most have shrewd ways of seeing that they get it." *What Do You Pay For Eyeglasses?* 22 Fortune 103 (Oct. 1940), cited below by the respondent. (Brief and Appendices for the Resp., p. 32, n. 14.)

making payments to physicians was a widespread business practice. In 1946 the Department of Justice was "informed that the rebating practice is industry wide." The Department meticulously supplied details which embraced Chicago, Dallas, Oklahoma City, Minneapolis, and Denver. In a number of instances the amounts taken by the physicians exceeded the sums retained by the opticians. The Department stated that "some individual physicians receive as much as $40,000 annually in rebates." "Moreover, the actual cumulative figures indicate that one group of physicians in Iowa received more than $42,000. One physician in a small town in Texas received almost $15,000, a sum equaled by physicians in Minneapolis, Waterloo, Iowa, Rockford, Ill., and other small communities." Since the practice was so widespread, there were several resolutions on the subject in the American Medical Association. Nor has the physicians' practice of taking rebates been carefully confined to eye-glasses. Doctors have similarly engaged in the practice of obtaining rebates from pharmacists and makers of braces and splints. "The development of roentgenology as an important medical specialty and the establishment of clinical pathologic laboratories to which physicians send patients for the making of highly technical and often costly tests have introduced new sources of rebates, kickbacks and commissions." (Resp. Brief in Opposition to Pet. for Certiorari, pp. 21-26.)

E. The issue before the Court spreads far beyond this immediate case. It extends into every nook and cranny of business life which is increasingly controlled and supervised by government. Each public regulation reflects a "public policy," and any outlay due to a deviation from that "policy" is necessarily involved in the principle which the respondent seeks to apply. Nor does the reach of this principle pause at the shifting borders of public regulation. As the Court of Appeals' decision vividly illustrates, the principle cuts deep into the whole complex of private rela-

tions between businessmen. No limitation is in sight,[33] for a principle of so called "public policy" is conveniently free from any restrictions which a rule of tax law normally implies.[34] "The meaning of the phrase 'public policy' is vague and variable; there are no fixed rules by which to determine what it is." *Steele* v. *Drummond*, 275 U. S. 199, 205 (1927).[35] See also *Twin City Co.* v. *Harding Glass Co.*, 283 U. S. 353, 356 (1931). Since the respondent is invoking some extra-statutory principle which is "unconfined and vagrant" (cf. *Schechter Corp.* v. *United States*, 295 U. S. 495, 551 (1935)), there are no discernible restraints upon the powers of censorship which he would eagerly assume in the process of collecting taxes.[36]

The Tax Court's opinion in this case illustrates that public policy is essentially indefinable unless vague generalities are considered a definition. The Tax Court defined public policy as "the public good. Everything that tends clearly to undermine that sense of security of individual rights, whether of personal liberty or private property, which any citizen ought to feel, is against public policy." Next the Tax Court redefined public policy as "the community common sense and common conscience extended and applied throughout the state to matters of public morals, public

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[33] Even where legal theories are relatively restrained, they have, "in an odd kind of way, the faculty of self-generating extension." *Texas* v. *Florida*, 306 U. S. 398, 434 (1939).

[34] Compare I. T. 3724, C. B. 1945, p. 57, and I. T. 3811, C. B. 1946-2, p. 70, with *Lela Sullenger*, 11 T. C. 1076 (1948).

[35] In the same case this Court warned that the principle of public policy "must be cautiously applied to guard against confusion and injustice." See *id.* at 205.

[36] The respondent's notion of his powers of censorship is not carefully confined to Section 23(a)(1)(A). He has sought to deny a charitable deduction on the ground that the charity's activities violated a local penal law. However, the First Circuit frustrated the attempt, observing that the meaning "of the word 'charitable' in a federal revenue act is a matter of federal, not local, law." *Faulkner* v. *Commissioner*, 112 F. 2d 987, 992 (C. A. 1, 1940).

health, public safety, public welfare, and the like; it is that general and well settled public opinion relating to man's plain, palpable duty to his fellow men, having due regard to all the circumstances of each particular relation and situation." Then the Court further defined public policy as prohibiting "that which has a tendency to be injurious to the public welfare." (14 T. C. at 1079-1080.). Surely in allowing the deduction of "ordinary and necessary" business expenses Congress did not authorize the respondent to censor deductions according to his views on "security of individual rights;" "common sense and common conscience;" "public morals, public health, public safety, public welfare and the like;" "man's plain, palpable duty to his fellow men.". Yet the decision below hardly authorizes the respondent to do less.

Certainly the respondent does not have any modest notion of the powers at his command in the name of "public policy." We do not have to speculate in this respect. For instance, in *F. L. Bateman, supra,* the taxpayer, who was in the freight forwarding business, pursued "a common practice" of paying "varying amounts to employees of railroads, and also industries." The payments were required because of "the congested condition of traffic and transportation, competition, and shortage of cars," and "were of great value to the company, not only in the successful operation of its business but in the production of business, with its resultant revenue." 34 B. T. A. at 367. Despite the obvious and intimate connection between the business and the payments, the respondent sought to disallow the deduction of the payments because they were "tips" designed to "create discrimination." *Ibid.* While the Board of Tax Appeals overruled the respondent, the case nevertheless reveals that the respondent's views of "public policy" are undisturbed by any apparent limitations.[37]

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[37] Judge Arundell indicated in his dissenting opinion in the Tax Court that there is little to distinguish the present case from the *Bateman* case. 14 T. C. at 1088. For a similar attempt to disallow tips, see *Marra Bros., Inc.*, 3 T. C. M. 1317 (1944).

According to the respondent, Section 23(a)(1)(A) is concerned with far more than "net income" or "actual profit." It is also concerned with "men's moral characters." See p. 11, *supra*. The respondent frankly regards Section 23(a)(1)(A) as a special delegation of power to regulate and disapprove business practices and procedures. As this case discloses, the respondent even assumes that the vast and shadowy area of professional ethics equally falls within his alleged power of supervision. He would convert Section 23(a)(1)(A) into a federal policing provision employed to implement not only federal policies, but local policies having nothing to do with federal taxation.

A principle which is unconfined and elusive in content is inevitably harsh and retroactive in application.[38] Again this case serves as a grim illustration—and the illustration speaks for the entire industry. For many years opticians, including the petitioners, excluded the rebates from their taxable net income and the respondent's agents repeatedly approved the exclusion. Since the rebates were a substantial portion of the opticians' *gross receipts*, the exclusion was necessarily a vital factor in business assumptions, calculations and risks. In the present case the rebates of the City Optical Company for 1942, 1943 and 1944 aggregated $178,687.05 (R. 179), as compared to a total book value of only $76,191.32 as of December 31, 1942. (14 T. C. at 1068.) Again, for 1943 and 1944 the rebates of the two Companies varied between 61 per cent and 72 per cent of their taxable income as adjusted by the respondent.[39] Despite its long-continued administrative practice and without any prior warning of a change in position, the Treasury has now reversed itself in the name of public policy and imposed a tax on what is plainly gross income. Disastrous financial consequences are inescapable under the retroactive impact of

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[38] We need not remind this Court of the evils of retroactivity in income taxation. See, *e.g., Helvering* v. *Griffiths*, 318 U. S. 371, 402-403 (1943); *Claridge Apartments Co.* v. *Commissioner*, 323 U. S. 141, 164 (1944).

[39] See pp. 4-5, *supra*.

the principle pursued by the respondent. Surely in enacting Section 23(a)(1)(A) Congress did not contemplate "so deadly a remedy" which no word in that statute implies or suggests. Cf. *Bruce's Juices, Inc.* v. *American Can Co.*, 330 U. S. 743, 754 (1947). Yet so "deadly a remedy" is unavoidable if the respondent may pass upon the social desirability of business outlays and evince his displeasure by taxing gross income.

The vast implications and consequences of the decision below were acutely anticipated in a penetrating appraisal of the respondent's public policy doctrine:

> "Once the courts attempt to deter undesirable business activity through the disallowance of various business expenditures, they must face a series of increasingly indefinite factual situations. The simplest is where the expenditure may be considered the penalty of a previous adjudication of unlawful conduct: these are the fines, judgments, and legal expenses. The Courts have said that public policy requires this method of deterrence only where there has been a prosecution by the government. The second situation is where either the actual expenditure or the activity in which it was incurred is in violation of law; here the expenditure is habitually disallowed. The third factual situation differs from the second in that while the activity is not in violation of law, nevertheless it is considered contrary to the best public interest.
>
> "In the first two situations, the sources of policy are confined to the criminal and regulatory statutes. Its application is limited to the general deterrence of violations of criminal statutes, and, in regulatory statutes, where there has been a previous adjudication of violations. In the third situation, the sources of public policy are not thus restricted; presumably these sources may be any expression, whether of judicial or legislative origin, of which activities are inimical to the public interest. The only limitations would appear to be two inarticulately expressed judicial standards: the ideal business man and the public welfare.
>
> "The rule in the first two situations may perhaps be justified by a principle of statutory construction that

the word 'lawful' may be read before a word of 'all-inclusive import'—in this case, before the word 'expense.' But even this principle is unavailing in the third situation, and justification of disallowances on grounds of effectuating public policy must overcome both the contrary import of the statutory language and the countervailing policy against the judicial conversion of a tax on net income into a possibly exorbitant tax on gross receipts. In addition, the extension of the concept of illegality arising from criminal and regulatory statutes to the concept of effectuation of public policy involves the acceptance en masse of all the artificiality such a vague standard must necessarily contain. The negligible relation of such a standard to the determination of what the tax burden of an individual taxpayer should be indicates that even though the restricted concept of illegality be retained, the broad concept of effectuating public policy should be discarded. To do so will, of course, result in the loss of haphazard additions to the national revenue. But increases in revenue should come either from an extension of tax liability or from an increase in rates, rather than from the distortion of a relatively rational system of taxation." Note, 54 Harv. L. Rev. 852, 858-860 (1941).

CONCLUSION.

As the language of Section 23(a)(1)(A) readily reveals, that provision specifies its own criteria of deductibility. The expense must be a "business" expense; it must be "ordinary;" and it must be "necessary." The statute provides no less and no more. In applying criteria which are nowhere to be found in the statute, the Court of Appeals has seriously erred. The decision of the Court of Appeals should accordingly be reversed.

Respectfully submitted,

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